

**Office of Chief Counsel
Internal Revenue Service**

memorandum

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CJSantaniello

date: November 20, 2001

to: Chuck Stuart, Team Manager, LMSB, Group 1123, Hartford, CT
Attn: Jeff Rizzardi, Revenue Agent, Group 1541, Norwalk, CT

from: Associate Area Counsel, LMSB, Area 1

subject: **Large Case Advisory Opinion -** [REDACTED]

This memorandum responds to your November 16, 2001 verbal request for advice regarding the taxpayer's assertion that the Commissioner may not properly require the production of documents relating to tax years outside the audit cycle. This memorandum should not be cited as precedent.

For the reasons set forth below, the documents in question are relevant to the COLI issue under examination. Consequently, any summons compelling the taxpayer to produce those records would more than likely be enforced in an enforcement proceeding commenced in the United States district court.

Issue

Whether a summons for documents pertaining to years subsequent to the current audit cycle, which documents are sought to verify that the taxpayer has satisfied the "four of seven" indebtedness-to-premium requirement of I.R.C. § 264(c), is enforceable. **U.I.L Nos. 264.00-00; 7602.00-00**

Facts

During the examination of the taxpayer's [REDACTED] and [REDACTED] returns, the examination team determined that the taxpayer invested in Corporate Owned Life Insurance (COLI) policies in [REDACTED]. As a result of its borrowing against the COLI policies, the taxpayer incurred significant interest expenses, which it deducted on the returns under examination.

To qualify for the deduction of interest paid with respect to COLI plans, taxpayers must not only satisfy the requirements of section 163^{1/} (i.e., that the amounts constitute interest paid or accrued on indebtedness), but also the requirements of section 264. Section 264(a)(3) denies a deduction for interest paid or accrued on debt as part of a pattern of borrowing on the cash surrender value of a life insurance policy. A pattern of borrowing is deemed to exist under section 264(c)(1) unless the taxpayer establishes that no part of four of the first seven years' annual premiums (or 4/7ths of the first seven years' total premiums) has been paid by means of indebtedness.

On [REDACTED], the examination team issued I.D.R. 0182, requesting various documents relating to the COLI issue. This I.D.R. contained the following language:

This follow-up request relates to Corporate Owned Life Insurance (COLI) plans acquired by [REDACTED] from [REDACTED] and [REDACTED] in [REDACTED]. It appears that [REDACTED] entered into a partial "unwind" (surrender) of their [sic] [REDACTED] and [REDACTED] COLI policies in the [REDACTED] policy years and paid off the remaining loans for both plans in the [REDACTED] policy years. These COLI transactions total in excess of \$[REDACTED] in [REDACTED] and [REDACTED].

To date, the taxpayer not complied with I.D.R. 0182 to the extent that the requested documents pertain to years outside the current audit cycle. By memorandum dated [REDACTED], the taxpayer stated its position that the requested information is irrelevant. Consequently, the examination team intends to issue a summons for the documents in question.

Discussion

Section 7602 authorizes the Service to examine, or summon if necessary, information and testimony which "may be relevant or material" to the Service's task "of ascertaining the correctness of any return." Summonses are enforceable in the United States district courts. Section 7604(a).

^{1/} All section references are to the Internal Revenue Code in effect for the taxable years at issue.

To be enforceable, a summons must meet the standards enunciated in United States v. Powell, 379 U.S. 48, 57-58 (1964):

[T]he Commissioner need not meet any standard of probable cause to obtain enforcement of his summons, either before or after the three-year statute of limitations on ordinary tax liabilities has expired. He must show that the investigation will be conducted pursuant to a legitimate purpose, that the inquiry may be relevant to the purpose, that the information sought is not already within the Commissioner's possession, and that the administrative steps required by the Code have been followed. . . .

Id. At 57-58.

The burden on the Commissioner has been stated as follows: "The burden is a slight one because the statute must be read broadly in order to ensure that the enforcement powers of the IRS are not unduly restricted." United States v. Kis, 658 F.2d 526, 536 (7th Cir. 1981). See also Alphin v. United States, 809 F.2d 236 (4th Cir. 1987) (citing and quoting Kis, 658 F.2d at 536 for the same proposition). Unless the party contesting the summons produces evidence to the contrary, the government can generally carry its burden by submitting an affidavit from the agent who issued the summons attesting to the fact that the above requirements have been met. United States v. Garden State National Bank, 607 F.2d 61, 68 (3d Cir. 1979). Once the government has made a preliminary showing, the burden then shifts to the summoned party to demonstrate that judicial enforcement of the summons would constitute an abuse of the court's process. Powell, 379 U.S. at 58; United States v. Davey, 543 F.2d 996, 1000 (2d Cir. 1976).

In ascertaining the relevance of the information sought, it is important to understand what the statute means when it states "may be relevant and material." (emphasis supplied) The Supreme Court, in United States v. Arthur Young & Co., 465 U.S. 805 (1983), described the relevance standard under section 7602 in the following way:

As the language of [section] 7602 clearly indicates, an IRS summons is not judged by the relevance standards used in deciding whether to admit evidence in federal court. Cf. Fed. Rule Evid. 401. The language "may be" reflects Congress' express intention to allow the IRS to obtain

items of even potential relevance to an ongoing investigation, without reference to its admissibility.

465 U.S. at 814 (emphasis added).

Consistent with Arthur Young, the First Circuit has stated that the relevancy requirement is met if the information requested "might have thrown light upon the correctness of the taxpayer's returns." United States v. Freedom Church, 613 F.2d 316, 321 (1st Cir. 1979) (quoting from United States v. Noall, 587 F.2d 123, 125 (2d Cir. 1978), cert. denied, 441 U.S. 923 (1979)). In this regard, information relating to years outside of those at issue can be summoned provided it may be relevant to the investigation. See Foster v. United States, 265 F.2d 183 (2d Cir.), cert. denied, 360 U.S. 912 (1959) (the test is whether the testimony or requested documents might shed some light on the issues). Thus, potentially relevant information is not limited to information generated in the years under examination.

The information requested by the [REDACTED] examination team not only meets the section 7602 relevancy standard but, as demonstrated by the Tax Court opinion in Winn-Dixie v. Commissioner, 113 T.C. 21 (1999), and the United States District Court opinions in IRS v. CM Holdings, 254 B.R. 578 (D. Del. 2000) and American Electric Power, 136 F. Supp.2d 762 (S.D. Ohio 2001), it also meets the higher relevancy standard under Fed. R. Evid. 401 for admissible evidence as well.

The taxpayers in Winn-Dixie, CM Holdings, and American Electric Power purchased leveraged COLI plans which operated similarly to the leveraged COLI plans purchased by [REDACTED]. In finding the respective COLI plans to be, inter alia, economic shams, each court reviewed and recited evidence concerning COLI plan operations which extended well-beyond the years at issue. Specifically, each court found this operational evidence to be particularly enlightening when assessing both the objective economics of the COLI plan as well as the taxpayer's subjective business purpose for the COLI transaction.

In reaching its opinion in Winn-Dixie, the Tax Court cited and relied upon the following facts derived from taxable years subsequent to the single year at issue in the case: (1) amounts billed to the taxpayer by the insurer and the manner in which such charges were satisfied through policy loans and partial surrenders; (2) policy value account transactions, including premiums, loans, surrenders, and interest credited amounts; (3) cost of insurance and policy expense charges; (4) claims stabilization reserve transactions; (5) annual net cash paid by the taxpayer;

(6) discussions among the taxpayer and its insurer, broker and plan administrator concerning 1995 tax law changes and potential strategies to "unwind" the COLI policies; (7) the taxpayer's termination of the COLI policies subsequent to the 1996 COLI legislation; and (8) the inherent conflict between Winn-Dixie's unwinding strategy and its purported business purpose for acquiring the COLI policies in the first instance. Similar facts were also considered by the district courts in CM Holdings and American Electric Power, and is similar or identical to the post-audit year information requested from [REDACTED]. These cases establish that the information requested is not merely potentially relevant, but is, in fact, directly relevant to the COLI interest deduction issue.

Based on our reading of the taxpayer's [REDACTED] memorandum, it appears that the its position may be based, in part, on a misunderstanding of what was in controversy in Winn-Dixie. In the section of the memorandum entitled "Facts before the Court in Winn-Dixie," the taxpayer acknowledges, through a quotation from the court's opinion, that the parties had agreed that Winn-Dixie's COLI plan satisfied the "four of seven" safe harbor provision under section 264. Thus, barring a sua sponte analysis by the court (which did not occur), the parties' agreement on this issue obviated any need for the court to factually examine whether the taxpayer had complied with the four-of-seven test. Thus, the inclusion of facts in the opinion for the purpose of section 264 would have been superfluous. In fact, the court's recitation of evidence generated beyond the years at issue was included in the court's opinion, not for the purpose of ascertaining compliance with section 264, but rather, for the purpose of ascertaining whether Winn-Dixie's COLI plan, in its entirety, possessed non-tax economic substance. As an example, the court stated:

Petitioner also recognized that circumstances might well change during that [60-year projected period] that would cause it to modify or terminate the plan. In fact, the COLI plan was impacted by legislation in 1996, and the COLI policies were terminated in 1997. However, for the first 2 years, the COLI plan was followed, and it produced results that were consistent with plan projections. We will, therefore, examine the economic substance of the COLI transactions by analyzing the projections that reflect the plan.

113 T.C. at 280-281.

Thus, after first reviewing the actual results of the COLI plan beyond the year at issue, the court concluded that, since the

taxpayer deviated from its original plan in response to a tax law change, the court must necessarily assess the substance of the transaction by examining the plan projections. The Winn-Dixie opinion again refers to Winn-Dixie's deviation from its projections when assessing the subjective business purpose for the COLI transaction. To wit:

Following the enactment of tax law changes in August 1996, which greatly restricted employers' deductions for interest on loans from company-owned life insurance policies on the lives of employees, petitioner terminated its COLI program.

Id. at 288-289.

Once again, the court makes use of factual information generated beyond the year at issue in finding that the taxpayer in Winn-Dixie did not have a genuine non-tax business purpose for its COLI transaction. Perhaps even more indicative of the probative value of COLI transactional information beyond the years at issue is the Eleventh Circuit's affirmation of the Tax Court. See Winn-Dixie v. Commissioner, 254 F.3d 1313 (11th Cir. 2001). In the last sentence of a one paragraph summation of factual information relating to Winn-Dixie's COLI program, the Eleventh Circuit stated that "Winn-Dixie participated until 1997, when a change in tax law jeopardized this tax arbitrage, and eased its way out." Id. at 1315. Later in its terse opinion the court stated as follows:

The [Tax Court] found, without challenge here, that the program could never generate a pretax profit. That is what Winn-Dixie thought when it set up the program, and it is the most plausible explanation for Winn-Dixie's withdrawal after the 1996 changes to the tax law threatened the tax benefits Winn-Dixie was receiving.

Id. at 1316 (emphasis added).

Thus, among the scant factual information included in its opinion, the Eleventh Circuit felt compelled to include factual information derived from operational evidence generated beyond the years at issue. Not only did such evidence prove to be relevant, but it was apparently highly influential to the court in agreeing with the Tax Court's specific finding that the COLI plan lacked a non-tax business purpose.

Similarly, the district court cases of CM Holdings and American Electric Power are replete with evidence extending beyond the years at issue. In both cases, such evidence was used not only

to determine a lack of compliance with the "four of seven" rule, but also to assess the economic substance of the respective COLI plans. For example, in section III.A.3.b.(1) of the CM Holdings opinion, the taxpayer's actions in response to the enactment of the Health Insurance Portability and Accountability Act of 1996 (HIPA) are cited as support for the conclusion that the taxpayer's COLI transaction lacked any non-tax business purpose. Interestingly, the court in American Electric Power noted the same post-HIPA evidence in support of its conclusion that the bulk of the COLI policy loans were real. Thus, not only is information from years beyond the taxable periods at issue relevant to the government's case in determining the tax implications of these protracted COLI transactions, it may also be relevant to any arguments available to the taxpayer regarding the business purposes of the transactions.

Based on the opinion of every court that has reviewed similar COLI transactions, the relevancy of the information requested is indisputable and any argument to the contrary is untenable. Accordingly, any summons issued for the requested information will, should the taxpayer not comply, more than likely be enforced in any subsequent enforcement proceeding.

We are simultaneously submitting this memorandum to the National Office for post-review and any guidance they may deem appropriate. Consequently, you should not take any action based on the advice contained herein during the 10-day review period. We will inform you of any modification or suggestions, and, if necessary, we will send you a supplemental memorandum incorporating any such recommendation.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney-client privilege. If disclosure becomes necessary, please contact this office for our views.

Since there is no further action required by this office, we will close our file in this matter ten days from the issuance of this memorandum or upon our receipt of written advice from the National Office, whichever occurs later.

Please call Carmino J. Santaniello at (860) 290-4075 if you have any questions or require further assistance.

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By: _____
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